

# Intra-Group Financing Relationships: German Ministry of Finance (BMF) Releases Draft on August 14, 2024

On August 14, 2024, the German Ministry of Finance (BMF) introduced a draft to amend the transfer pricing guidelines issued on June 6, 2023. This draft focuses on new regulations concerning financing relationships, following the revision of Section 1 of the German Foreign Tax Act (AStG) and the introduction of Sec. 1 para. 3 lit. d and para. 3 lit. e AStG as part of the Growth Opportunities Act. These changes significantly impact companies subject to taxation in Germany that engage in cross-border financing relationships.



## Overview

The provisions of Sec. 1 para. 3 lit. d and para. 3 lit. e AStG came into effect on January 1, 2024. However, they do not apply to interest expenses arising from financing relationships that were legally agreed upon before January 1, 2024 (e.g., based on an intra-group loan agreement) and

were actually executed before this date (generally, grandfathering protection). This protection is void if the long-term debt relationship undergoes significant modifications after December 31, 2023, or is extended beyond December 31, 2024.

Notably, the BMF provides grandfathering protection for loans granted before January 1, 2024, regarding the extended documentation requirements under Sec. 1 para. 3 lit. d AStG. However, no such protection is granted for the new regulation under Sec. 1 para. 3 lit. e AStG concerning the classification of certain services as low-function and low-risk, implying that even loans granted before January 1, 2024, may require review.

## Arm's Length Principle in Financing

The assessment of whether an intra-group financial transaction is classified as arm's length and qualifies as debt capital is now governed by Sec. 1 para. 3 lit. d s. 1 no. 1 AStG. This regulation requires the taxpayer to credibly demonstrate that, for a cross-border financing relationship:

- the debt service could be met from the outset for the entire term.
- the financing was genuinely required and used for a business purpose.

Additionally, Sec. 1 para. 3d no. 2 AStG stipulates that the interest rate paid on a cross-border financing relationship must not exceed the rate that would have been agreed upon with an independent third party (e.g., a bank).

Failure to meet these criteria risks disallowance of the interest expense as a deductible business expense, leading to a higher tax burden on the German entity.

## Expanded Documentation Requirements for Financing

Under Sec. 1 para. 3d no. 1 and 2 AStG, the documentation requirements related to debt service capacity and the use of funds are expanded. The draft BMF letter outlines the requirements of the new § 1 AStG and clarifies specific issues related to providing evidence of these criteria.

To credibly demonstrate the prerequisites, taxpayers must initially provide proof that these conditions are likely to be met, for example, through appropriate forecast calculations showing that debt service can be sustained and that funds are used appropriately.

It must also be demonstrated that the financing is economically necessary and used for a business purpose, with particular emphasis on the borrower's debt capacity and the intended use of the borrowed funds. For instance, while borrowing for profit distribution is generally acceptable, depositing loan funds into a money market or cash pool account is usually not considered a valid business purpose.

The BMF further clarifies that the need for follow-up financing does not inherently contradict the arm's length principle; rather, it depends on a comprehensive assessment of the circumstances.

However, if a forecast calculation showing that the loan and accrued interest can be serviced is not provided, follow-up financing may not be considered arm's length.

Moreover, the BMF notes that, in certain cases, high-risk financing, such as for a start-up, can still be considered arm's length.

## Arm's Length Interest Rate

To determine an arm's length interest rate under Sec. 1 para. 3d s. 1 no. 2 AStG, the rating of the corporate group is primarily used. Alternatively, a derived rating of the borrower can be employed if the taxpayer can demonstrate that it aligns with the arm's length principle.

The BMF establishes a hierarchy for determining the group rating, with the highest priority given to published group ratings, followed by existing ratings of the group's parent company, unpublished ratings from paid rating agencies, or a synthetic rating.

If none of these are available, the rating can be determined using qualitative factors through rating software.

Simplified methods, such as using the group's financing costs with third parties, may also be employed, provided the rating is traceable,

reproducible, and free from distortions due to intra-group transactions.

To validate the arm's length nature of a derived rating, it is particularly important to document group support according to the established criteria of leading rating agencies. Qualitative factors must be considered, ensuring that financial results from transactions not in line with the arm's length principle are excluded. The current rating methodology must also be applied consistently.

## Financing Relationships as Low-Function and Low-Risk Services

According to Sec. 1 para. 3e AStG, intra-group financing relationships are generally classified as low-function and low-risk services.

The draft of Sec. 1 para. 3e AStG concretizes this much-debated provision and confirms the BMF's interpretation as outlined in the 2023 Transfer Pricing Guidelines. It is based on the Federal Fiscal Court's case law and provides that arm's length price for providing debt capital between related parties is typically determined using the comparable uncontrolled price method.

Key comparability factors include the purpose of the loan, regulatory conditions, term, potential currency and ESG risks, loan volume, and collateral. The specific credit risk of the borrower (creditworthiness) must also be considered.



Engaging in activities listed under Sec. 1 para. 3e AStG does not automatically require the tax authority responsible for determining the transfer price to classify it as a low-function and low-risk service. The tax administration may assert a different classification if supported by an appropriate functional and risk analysis. The same high standard of documentation applies to the taxpayer, meaning the criteria must be met with a high probability.

## Tax Consequences and Risks

If the debt service capacity or economic necessity for the financing cannot be substantiated, or if the arm's length nature cannot be adequately demonstrated, the tax authorities or auditors intend to reverse the financing to the extent of the non-arm's length portion. Accordingly, there is a tax risk that the deduction of interest expenses as business expenses for cross-border financing relationships within the scope of Sec. 1 para. 3d and para. 3e AStG may be denied, leading to a higher tax burden.

While the legislative justification initially assumed a denial of the deduction of interest expenses as business expenses or even in certain cases the classification of a granted loan as equity in line with the OECD guidelines with an impact on the development of tax values, the BMF in its current draft proposes a more practical interpretation in the form of an off-balance adjustment to the extent of the non-arm's length portion.

## Conclusion

For new intra-group financings initiated after January 1, 2024, greater consideration of tax aspects will be crucial. In particular, the German borrowing company and the group face increased

documentation and evidence requirements, which extend to the debt service capacity and use of funds per the specifications of Sec. 1 para 3d AStG. The new rules may also necessitate maintaining a group rating, which could pose practical challenges. Additionally, risks exist regarding the classification of (existing) loans as low-function and low-risk services under Sec. 1 para. 3e AStG.

The new regulations and the expansion of Sec. 1 AStG through para. 3d and para. 3e introduce significant tax risks, including the potential denial of interest expense deductions for cross-border financing relationships if the new requirements are not met, resulting in a correspondingly higher tax burden for the German entity. The draft BMF letter of August 14, 2024, is a welcome development as it clarifies practical uncertainties regarding the practical requirements of the new regulation and offers a pragmatic approach to handling the non-arm's length portion of financing expenses through off-balance sheet adjustments.

It is essential for companies to review existing and future cross-border financial transactions to ensure compliance with the new regulations, mitigate tax risks, and expand the documentation of financial transactions in light of the new requirements under Sec. 1 AStG.

## Do you have any questions on this topic?

Do you need support? Simply contact our experts Henning Straeter and Sebastian Siegmund.

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